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Mortgage Securities: Slow MBS Market Hikes Fraud Risk

By Glen Fest
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Investment banks that buy mortgage-backed securities have a deeper worry than the billion-dollar estimate of fraud in lending each year. The fear is that it could be much worse.

Foreclosures and delinquencies are rising, and with it the realization that it's likely to be more than credit risk going bad. Fraud that's hidden during good times-fudged income on home equity applications or flipping schemes by shady appraiser/broker teams-comes to the crest when prices and sales stagnate. Secondary market investors are fretting just how deep the potholes may be in their large-scale securitization pools.

Evidence of that tide is already sprouting, from both market activity and the launch of IT tools to give secondary market buyers additional fraud prevention abilities beyond looking at "bid tape" data on loans they are offered.

"The capital markets want to understand more about these portfolios than they used to have to worry about," says Financial Insights credit and banking research director Christine Pratt.

Since these portfolios have become more loaded with non-conforming loans in recent years, firms in the secondary markets are starting to respond with more scrutiny and returning more questionable loans back to lenders. Several lenders in the fourth quarter reported more set-asides or heightened activity in repurchasing volume, stemming from rising early-and first-payment defaults that set off fraud alarms with investment banks. Higher-than-expected fraud losses took some blame in HSBC's bombshell February decision to shift an extra $1.76 billion in capital to cover bad debts in secondary holdings weighted with subprime and "piggy back" loans.

"Over the past several years, I would say [fraud] was not necessarily an active point of concern in the diligence process" of secondary investors, says Kevin Cloyd, evp of New Century Mortgage Corp., headquartered in Irvine, CA. "What led to the concern was a higher degree of the layered risk products being originated."

Mortgage risk technology vendors that normally roam in the lending side of the space are prepping for this new need with tools that can help with a second look at loans in the secondary market. CoreLogic, a Sacramento risk management and fraud firm acquired in February by First American Corp., extends an investor services module to secondary buyers that builds on its automated valuation specialty to lenders. Carlsbad, CA-based BasePoint Analytics has recently updated its

core FraudMark suite for lenders with new pattern recognition metrics that will score loans and pools against the likelihood of fraud.

"We actually see this as something they're going to use going forward to influence their pricing of pools," says BasePoint CEO Tim Grace. Higher fraud scores will influence the investors to pay for more certain pools, and drop the bids for low-scoring collections. BasePoint takes the usual data collected by investment banks-front-end and LTV ratios, top-line borrower and property information, program details, etc.-and accentuates them with pattern-recognition data culled from loans BasePoint has previously screened for lenders.

Besides knowing more to better rate current bids for risk, bans can also retro-score existing pools. Grace says the BasePoint's investor-side fraud model has identified problem loans within a 5 percent performance mark of its originator-oriented software working with a deeper applicant view.

Additional secondary fraud monitoring is a reaction to the lending practices that increasingly transferred more risk to the securities market, Pratt says, such as relaxing mortgage insurance requirements. "The largest [lenders] are willing to take more risk with mortgage lending, because they really don't have that risk on their balance sheets anymore," says Pratt.

Another factor is the realization that fraud risk can't be lowered with more credit risk profiling. "We heard many lenders were moving credit score [requirements] up in order to alleviate concern of future default," says Grace. But higher scores in non-prime loans have double the fraud rate-since crooks aren't going to create shaky, edge-of-bankruptcy profiles to get these loans. "Intuitively, that makes sense," Grace says. "Why would a high credit score be going to a nonprime lender?"
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